FIRST COMMUNITY BANK

March 6, 2006 DOCKET NO. OP-1248

Honorable Jennifer J. Johnson
Secretary, Board of Governors
of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Comments on the Interagency Proposed Guidance—Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices

Dear Sirs and Madams:

We appreciate the opportunity to comment on the proposed Guidance on Concentrations in Commercial Real Estate Lending and Sound Risk Management Practices. We support sound risk management of commercial real estate lending. However, we have reservations about the Guidance and would suggest modifications. In summary our concerns follow:

1. The Guidance does not focus on where the risk lies in commercial real estate ("CRE") lending. The Guidance assumes that only two broad categories of CRE lending be the basis for applying concentration guidelines and—when the concentrations reach an arbitrary percentage of capital-- the Guidance suggests that special measures be taken—measures which can have serious impacts on the institution (alternatives are discussed later);

2. The Guidance suggests that any lending which involves commercial real estate is to be classified as a CRE loan[1]. In many markets, real estate is not only the most stable collateral; it is the only meaningful collateral.

3. The Guidance treats all markets with the same risk profile. The Guidance lacks guidance on in what markets CRE lending is more or most risky. Meaningful Guidance should isolate market characteristics which lead to risky CRE lending. A broad brush risk treatment may result in inherently discriminatory applications to regional institutions;

4. The Guidance definitions of key terms or definitions are vague or misleading. For example, "CRE" lending, "hard equity", "developer" and similar key terms are either not defined or are not clearly defined, and often have no common meaning in the financial industry.

[1] With the lone exception of owner occupied properties.

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5. Most disturbing, regulation, examination and enforcement of the Guidance should not rest on "case by case" applications since fundamental fairness requires that there be consistent regulatory treatment among banks. Predictability is indispensable to effective regulation.

While our introductory comments may seem critical, we applaud the concept that CRE lending risk may be avoided or lessened by sound risk management practices and effective underwriting. Those practices should be in place and enforced across the board in each agency promulgating the Guidance.

To expand on the key points stated above, we would offer the following comments.

Identification of Institutions with CRE Concentrations

1. Not all CRE lending is equally risky as the Guidance suggests. For example, commercial real estate, even some types of construction lending with short gestation periods may be less risky than other types of real estate development. Certain residential development has minimal risk in rapidly growing markets—markets which have a stable job market. Indeed, pre-sold 1-4 unit residential construction should not be included in the CRE concentration lending matrix. Also, neither the Inter-Agency Guidance nor the new Call Report instructions provide for the segregation of commercial loans sorted by SIC code. It is a relatively common practice for community banks to take real estate collateral as additional support for business loans. This may lead to inappropriately classifying as commercial real estate loans under the Guidance what is properly classified as commercial loans, *eg.* loans which have real estate collateral but are not dependent upon the value of real estate or real estate income for repayment of debt.

2. Definitions of CRE for determining concentrations are flawed or unfairly vague. Statistics gathered by the Federal Reserve Bank of San Francisco (12th District)[2] show CRE concentration at record levels in the 12th District as opposed to the rest of the U.S. (2nd Quarter 05 240% U.S., 394% 12th Dist.)[3] Stable markets exhibit common characteristics: (a) absence of "housing bubble" qualities, (b) stable job markets and avoidance of military base closings, (c) extension of extensive infra-structure to developing areas, (d) steady growth unrelated to speculative ventures and similar analyses. There are others beyond the fair length of this comment.

3. Any definition of CRE concentration which includes pre-sold 1-4 residential construction loans is flawed. The risk of such projects has historically been minimal. However, such projects will be included in the most restrictive concentrations formulae in the Guidance. Similarly, to permit inclusion of "developer" unsecured loans without a clear definition of what "developer" means, is equally subject to untrammeled discretion. Does an unsecured loan by a financial institution to a wealthy individual to develop an

[2] Presented at the Annual Directors Conference, November 4, 2005, "Commercial Real Estate Concentrations—Regulatory Panel Discussion."

[3] *Ibid.* at 8. Although the same data shows CRE delinquencies are near record lows.

isolated project on a short time frame qualify as a CRE loan? What about a similar series of projects over a three year period, where the borrower has no other real estate developments?

4. Again, we are concerned by the principle that the Guidance will be applied on a "case by case" basis under any circumstance.

Risk Management Principles

Good risk management practices should occur in all facets of lending. While real estate lending may have inherent volatility, almost all lending in growing industries exhibit the same characteristics: energy (especially oil and gas), software and technology, etc. We accept most of the risk management principles stated by the Guidance, but some comments follow:

1. In the area of Board and Management and Oversight, we support the involvement of a Board or appropriate committees in monitoring CRE lending strategies and policies. However, we suggest that the proper "flow" is from management giving the Board its recommendation for clear guidance for management of CRE lending and strategy with appropriate Board approval, oversight and monitoring. We also support consistent firm inter-agency enforcement of Inter-Agency Guidance for Real Estate Lending Policies, including appraisal regulations and related guidance. Until all agencies uniformly enforce these other, related guidance the emphasis on CRE concentration will be misplaced. Such sporadic enforcement makes "case by case" application of this Guidance especially dangerous.

2. Although Strategic Planning must be emphasized, the Guidance states a level of faith in the secondary market that is misplaced. The best of the regional bank's underwriting procedures exceed those of the secondary market.

3. We agree that Underwriting must be based on a careful review of internal and external factors that affect the institution. We express some concern that underwriting standards should include sensitivity or stress-testing because such procedures are not reality tested or reliable in all markets.

4. The standard for "maintenance of hard equity" is not defined. What is "hard equity"? As usually defined in the current lending culture it may mean a form of underwriting far removed from that suggested in the Guidance. [4]

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[4] From American Lending Services, Glossary of Mortgage Terms. [http/www.americanlendingservices.com/glossary.htm] "HARD EQUITY Generally refers to loans made on property value and the ease with which the property can be sold. Lenders making this type of equity loan generally lend at no higher than 65% LTV. True equity lender fund do not consider, bad credit, previous bankruptcies or verified income. Loans are funded very fast and they charge commensurate with their speed and the risk of the situation." From US Express, Commercial Lending

5. The setting of minimum standards on an institution wide basis for borrower net worth and property cash flow are worthy goals, but not realistic. As stated before, faith in the secondary market's underwriting standards is too lax a standard.

6. We agree that in the area of Risk Assessment and Monitoring of CRE Loans, the establishment and maintenance of risk rating CRE exposures, accounting monitoring, identifying of loan impairment, etc. are important. However, assignment of risk ratings to CRE loans should be based on market conditions.

7. In the area of Portfolio Risk Management, the Guidance may place too much focus on MIS capabilities and the secondary market without regard to effectiveness, availability and expense. Portfolio stress testing in its current form is not reliable as an indicator of true risk.

Capital Adequacy

It would be difficult to fault the logic and validity of the Guidance's reference to capital adequacy since the main message is a restatement of existing concepts. However, given the Guidance's acceptance of "case by case" regulation, a requirement that an institution may have to exceed normal "well qualified" capital standards because of "case by case" enforcement should be reconsidered. As such, the Guidance may be used to sanction inconsistent regulatory treatment among institutions.

We appreciate the opportunity be a part of this important process and stand ready to give further information as needed.

Sincerely,

Michael R. Stanford
Chairman and Chief Executive Officer
First Community Bank

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credit, previous bankruptcies or verified income. Loans are funded very fast and they charge commensurate with their speed and the risk of the situation." From US Express, Commercial Lending Glossary. [http://www.usexpress.com/commercialloans] "Hard Equity: High interest rate financing."